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## Chapter 2

# **CHALLENGES OF MACROECONOMIC STABILITY: A SPEED LIMIT ON CROATIA'S ACCESSION TO THE EUROPEAN UNION?**

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## **ABSTRACT**

This paper analyses three issues that could potentially affect macroeconomic stability and hence the speed of Croatia's accession to the European Union (EU): (i) Can the economy continue to rely on domestic demand as the main source of growth or is stronger reliance on exports necessary in the medium term? (ii) Is the external current account deficit in Croatia "excessive" and how have high deficits been corrected in the past? (iii) Does the expansion of bank credit to the private sector carry the seeds of macroeconomic instability? The paper argues that clearer signs of healthier growth have emerged since 2000, and that the Croatian economy should be able to adjust to the widening external deficit in 2002–03 in an orderly manner. However, there are reasons to be concerned about the expansion of private sector credit, as recently it has been financed largely by foreign borrowing. Large capi-

*\* The views expressed here are those of the author and do not necessarily represent those of the Bank for International Settlements. The author is taking part in this project as an independent researcher. Helpful comments from Ante Čičin-Šain, Andrea Mervar, Katarina Ott, Sandra Švaljek and two anonymous referees are gratefully acknowledged.*

tal inflows are likely to become the main challenges for macroeconomic policy in the run-up to Croatia's EU accession. Policy makers will in particular have to address the so-called "Tošovský dilemma", i.e., set interest rates at an appropriate level: setting them too high would invite excessive short-term inflows, while setting them too low would lead to excessive investment and thus inflation.

### **Key words:**

Croatian economy, enlargement of the European Union, transition economies, macroeconomic stability, economic growth, current account reversals, bank lending, banking system vulnerability, capital inflows

## **INTRODUCTION**

Many Croatian citizens presently hope and expect that Croatia will join the EU in 2007. Since the government submitted its EU membership application in February 2003, the ability to meet the conditions for EU accession has become the subject of almost daily assessments in virtually every sphere of economic, social and political life in the country. Macroeconomic stability is usually not seen as a major issue in this context. One reason is that good macroeconomic performance is not *per se* a condition for the accession: the key economic criteria are the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union. As the experience of Greece, Ireland, Portugal and Spain around the time they joined the EU has shown, these criteria can be satisfied even without a distinguished record of macroeconomic performance. Another reason is that macroeconomic stability is now largely taken for granted – low inflation, a stable exchange rate and a reasonable growth rate have been maintained since late 1993 despite considerable changes in the domestic and external economic environment.

Over the past year, however, the Croatian economy has started to face some new macroeconomic challenges. This paper focuses on three issues in particular: (i) Can the economy continue to rely on domestic demand as the main source of growth or is stronger reliance on exports necessary in the medium term?; (ii) Is the external current account deficit in Croatia "excessive" and how have high deficits been corrected in the past?; and (iii) Does the expansion of bank credit to the

private sector carry the seeds of future macroeconomic instability? These issues may have an important bearing on the speed of Croatia's accession to the EU. For instance, evidence that the economy returns quickly to a normal growth path following a reversal of current account deficits provides certain assurance that rapid growth could be sustained in the medium term, which should facilitate Croatia's accession efforts. On the other hand, evidence that adjustment is slow or partial may indicate that imbalances are accumulating. In that case, the imbalances may eventually have to be resolved through a crisis, which is bound to be costly in terms of growth and could delay Croatia's accession to the EU.

The main message of the paper is that there are reasons for cautious optimism on the outlook for continued macroeconomic stability. First, evidence of healthier growth seems to have emerged in the past few years (see Section 2). Contrary to widespread belief, the role of private consumption as a source of growth has not increased dramatically in recent years, and the share of consumption in GDP has yet to reach levels considered to be normal at this stage of development. More importantly, investment has strengthened and its structure has improved, while government consumption is no longer a major driver of growth. On the external side there is clearly considerable room for stronger and cyclically more stable contribution of exports to growth. However, a review of the experience of countries that have followed an export oriented growth strategy cautions against heavy intervention to promote selected export industries. This experience also points to the key role of strong domestic competition for sustainable growth.

If one admits that growth in the long term need not be driven solely by exports and that strong contribution of domestic demand is essential for balanced growth, a key question becomes how the economy adjusts to occasional surges in domestic demand and external deficits. The conclusion in Section 3, which studies past episodes of current account adjustment, is on the whole encouraging: the Croatian economy has so far reversed current account deficits fairly quickly. This provides at least some assurance that the correction of the external deficit, which widened considerably in 2002 and the first half of 2003, could proceed in a more or less orderly manner, i.e., through slower growth of private consumption, imports and investment on the one side, and a rebound in exports on the other.

As regards the credit expansion, the assessment in Section 4 is more cautious. The latest lending boom has exceeded a common benchmark for the "safe" expansion of private sector lending. More impor-

tantly, the expansion has been almost entirely financed by foreign borrowing, raising concerns about the accumulation of external debt and banking system vulnerability, despite the fact that prudential indicators for the banking sector are at present relatively favourable.

Concluding the paper, Section 5 elaborates on some challenges for macroeconomic policies that are hardly being discussed in Croatia at present. In particular, based on the experience of other accession countries, it seems likely that the main challenge in the run-up to the EU accession will be how to handle large capital inflows. Such inflows pose a fundamental dilemma for monetary policy to which there are no clear answers. But the more policy makers know about other countries' experiences, the greater the chances that this symptom of success will not be a harbinger of instability.

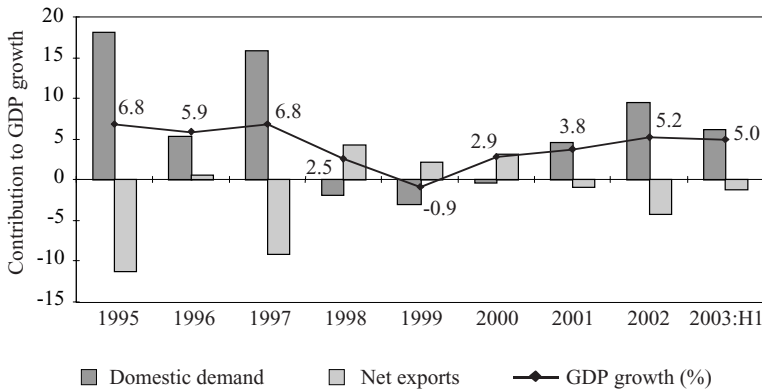
## **SOURCES OF GROWTH: DOMESTIC DEMAND VS. EXPORTS**

What is exactly the record of growth in Croatia in recent years? Has economic growth been sacrificed for the sake of maintaining low inflation and exchange rate stability, as many critics have argued? Has more recently the *quality* of growth been sacrificed for the sake of temporarily raising the *rate* of GDP growth through a “boom” in private consumption and public investment? Or has the growth performance become more sustainable in recent years? This section attempts to shed some light on these questions.

### **Signs of healthier growth since 2000**

When analysing sources of growth it is common to look at contributions to GDP growth rather than growth rates of different components of GDP.<sup>i</sup> Figure 1 thus shows data on GDP growth and its sources from 1995 through the first half of 2003. This period was chosen because macroeconomic performance in earlier years was severely distorted by the effects of the Homeland War (which partly also affected the 1995 data) and the initial stages of economic transformation. The average annual growth rate during this period was 4.2%. Three points stand out.

Figure 1 GDP growth and its sources, 1995–2003 (percentage points)

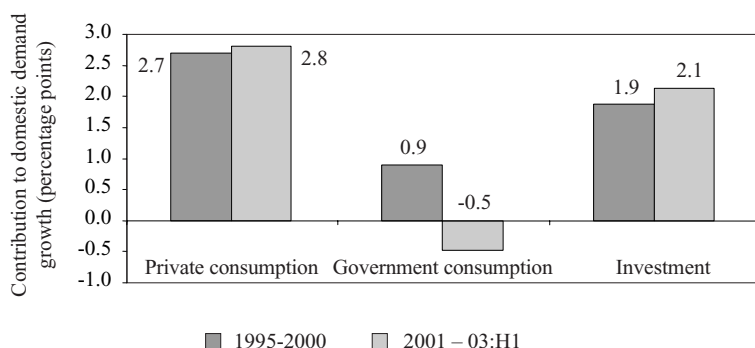


Source: Croatian Bureau of Statistics; author's calculations

- The main source of growth since 1995 has been domestic demand. Because of weak performance of exports relative to imports, the contribution of the external sector (measured by net exports, that is, exports minus imports of goods and services) was on average negative over this period. The external sector was a more important source of growth than domestic demand only during the period of weak growth in 1998–2000. However, except in 2000, net exports made a positive contribution to growth because of import compression rather than export expansion.
- In 1995 and 1997, the sources of growth were clearly unbalanced. However, in both cases the imbalance was corrected in the subsequent year (see Section 3). Both these years were also exceptional in that growth of domestic demand was driven by the post-war recovery of private consumption and investment in reconstruction. This is not surprising given that private consumption declined by 8% in real terms between 1991 and 1994, and investment by 6.5%.
- In 2002 and the first half of 2003, there was a similar but smaller imbalance between the domestic and external sources of growth. The issue here is, hence, to what extent this imbalance will be reversed by the end of 2003 and in 2004. Data for the third quarter of 2003 and current projections for the full year indicate that adjustment is already underway (see Section 3), so it remains to be seen whether it will be sustained.

To gain further insight into the question of growth sustainability, Figure 2 decomposes domestic demand growth. One can easily notice changes in the composition of growth between the period 1995–2000 and the period since 2001. Thus, while the role of personal consumption as a source of growth has been on average more or less constant, government consumption has played a significantly smaller role as a source of growth since 2001. Another positive development has been a strong revival of investment since 2001, in particular after negative contributions to GDP growth in 1999 and 2000.

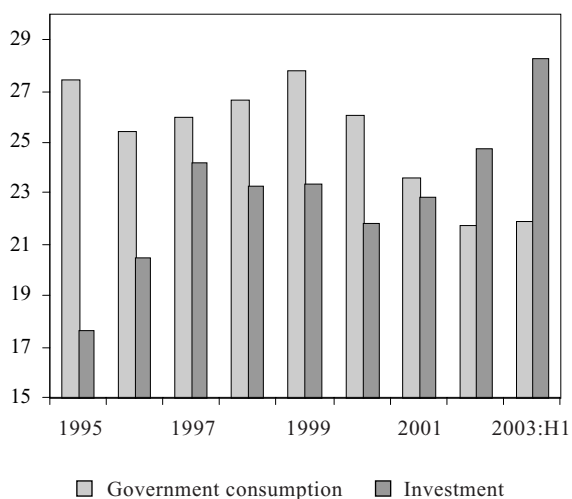
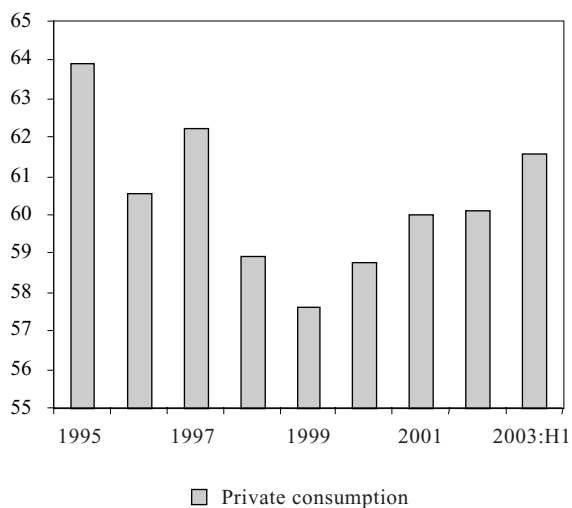
*Figure 2 Changes in sources of domestic demand growth (period averages)*



*Sources: Croatian Bureau of Statistics; author's calculations*

Changes in GDP shares of aggregate demand components also suggest that the pattern of growth may have become more sustainable in the past few years. Figure 3 (left panel) indicates that the rising share of private consumption since 2000 reflects a recovery from a trough in 1999. In fact, the share of private consumption in the first half of 2003 (about 61% of GDP) was lower than in 1995 (64% of GDP). By comparison, the average share of private consumption in GDP for a sample of the 23 largest emerging market economies during 1980–2002 was 73% (in the Czech Republic, Hungary and Poland, from 71–75%). Thus, rather than being excessive, one could argue that private consumption in Croatia has yet to catch up with a level that can be considered normal at this stage of economic development. Figure 3 also makes clear the decline in the share of government consumption (from 28% of GDP in 1999 to 22% since 2002), and the sharp increase in the share of investment.<sup>ii</sup>

Figure 3 Composition of domestic demand, 1995-2003:H1 (percent of GDP)



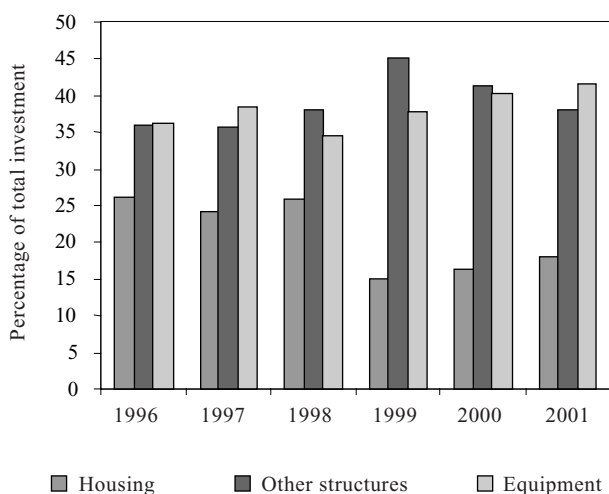
Source: Croatian Bureau of Statistics

Changes in the structure of investment have also been encouraging. Between 1996 and 2001, the share of private investment rose from



72% to 77% of the total, while that of public investment fell from 28% to 23%. Furthermore, the share of equipment rose, indicating a shift to a more growth-oriented structure of investment (Figure 4). In international comparison, the share of investment in Croatia (about 25% of GDP in 2002) was the same as the average for a sample of the 23 largest emerging market economies between 1994 and 2002, but lower than in the more advanced transition and emerging economies, where investment accounts for 28–33% of GDP. Thus, Croatia also has to catch up – rather than slow down – as regards the rate of investment.

*Figure 4 Composition of investment, 1996-2001*



*Source: Croatian Bureau of Statistics*

A final point to note is that Croatia's exports of services have become larger than its exports of goods since 2001. Thus, focusing on merchandise exports, which have stagnated at about \$4.5 billion per year since 1995, ignores the other, much more dynamic half of Croatia's total exports – that of services. And when exports of services are taken into account, the share of exports of goods and services in GDP has increased significantly in recent years, rising from under 40% of GDP in 1998 to 46% in 2002. Since Croatia's exports are highly correlated with imports, the share of imports has also increased, but by less than the share of exports.

In summary, recent macroeconomic performance points to several signs of healthier growth since 2000. In particular, there has been an improvement in the structure of domestic demand. If these trends are sustained, growth will have firmly shifted towards a healthier pattern. One should not forget, however, that the main components of growth continue to follow a rather pronounced cyclical pattern, with periods of rapid expansion in domestic demand and deterioration in net exports followed by contraction (or slower growth) in domestic demand and improvement in net exports. This growth pattern is fairly typical of emerging market economies and has been also observed in successful EU accession countries over the past few years. For instance, the shift towards domestically driven growth became apparent in 2001 and has strengthened in 2002–03 throughout central Europe because of the stagnation of the western European export market (see Chapter III in BIS, 2003).

## **Changing views on export-oriented growth**

Despite indications that growth trends in Croatia are on the whole becoming sounder, it is worth asking whether growth could be accelerated through greater reliance on exports in the medium term. This question is also relevant in other Central and East European countries. With relatively low inflation, stronger growth and improving prospects of EU accession, a key challenge has become the need to develop a policy environment that will facilitate faster catching up with EU countries. Since some of the fastest growing economies since the 1960s have been the Asian countries, which have sustained high growth rates of exports, there has been considerable interest in their export-led growth strategy. It may therefore come as a surprise that recent studies of the Asian experience cast doubt on the benefits of an export-oriented growth strategy and its applicability in Central and Eastern Europe. Four results stand out.

- The empirical evidence on the positive long-run relationship between exports and economic growth is weak. Medina-Smith (2001) reviewed for the United Nations Conference on Trade and Development (UNCTAD) 42 empirical studies on exports and growth published since the late 1960s. He concluded that recent econometric evidence does not support the view that exports cause growth, as many economists maintained until recently and as early studies suggested. For instance, internal forces – in particular strong domestic

- competition – have been more important for Japan’s economic success in the post-World War II period than external trade (Boltho, 1996).
- Useful lessons from the Asian experience that are applicable to EU accession countries are not the ones usually emphasised in public discussions about exports and growth – subsidies to export industries. Rather, the useful lessons are fairly commonsense and “boring”: the importance of sound macroeconomic policies and strong domestic competition; an outward oriented trade regime; and public support for the development of trade infrastructure (export financing and insurance, market research, dissemination of information about foreign market opportunities, training and education in export-related skills and technology transfer) (Kokko, 2003).
  - Rather than being an example to follow, heavy intervention is the single most important negative lesson of the Asian experience. Selective large-scale export promotion schemes have been very costly in terms of growth and efficiency. Such schemes have often been interpreted as a signal that market prices and short-term nominal profits do not matter in heavily supported industries. The moral hazard involved has contributed to too much risky investment, resulting in excess supply and downward pressure on prices. In addition, the sectors that have not been supported have faced a heavier tax burden and crowding-out in credit markets, with further complications if the export promotion measures have been financed through foreign borrowing.
  - Finally, it is worth noting that, since the Asian crisis of 1997–98, the Asian emerging economies themselves have started to move away from reliance on exports to domestic demand as a more stable source of growth in the long term. One reason has been that, by expanding capacity in export industries and neglecting non-tradable sectors, these countries have become overly dependent on external demand and began to suffer from inefficiencies in the domestic markets. The crisis has also exposed some weaknesses of the export-oriented model that had been long ignored, such as the tolerance of financial repression and of opaque governance (Asian Development Bank, 1998).

## **What are the implications of these findings for the current debate on exports and growth in Croatia?**

First, even though the benefits and applicability of an export-oriented growth strategy seem to be more limited than previously thought,

one should not jump to the conclusion that the observed pattern of growth in Croatia is satisfactory. As noted above, domestic demand and net exports have been fairly volatile. Such pronounced cyclicity, although a feature of the great majority of emerging market economies, does not provide assurance that rapid growth in any particular year will be sustained over a longer period.

Second, instead of trying to develop a wide-ranging “export strategy” or reinvent industrial policy, it is far more important for sound economic development to foster domestic competition and the traditional – i.e., limited – economic roles for the government: a well-functioning legal and judicial system, transparent regulation of market competition, and the provision of infrastructure, education, and social services in those cases where the market outcomes are not satisfactory. Judging by the experience of present EU members and successful transition economies, such efforts would not only help develop a vibrant export industry but would also well serve Croatia’s EU accession efforts.

## **ADJUSTING TO CURRENT ACCOUNT DEFICITS**

Have the size and variability of the current account deficits in Croatia been excessive? Economists’ and policymakers’ views of current account imbalances have undergone several changes over the last 25 years. Currently there is no consensus, either with respect to the critical size of such deficits or their usefulness as indicators of a potential balance of payments or currency crisis. For a while it was thought that external deficits did not matter if the public sector was in equilibrium and the deficits reflected private sector decisions. This view (also known as the Lawson Doctrine) was challenged by the Asian financial crisis of 1997–98, in which external indebtedness of the private sector led to economy-wide crises even though public sector positions were in balance. Some now argue that when the current account deficit reaches a certain critical size it becomes a source of concern regardless of whether the domestic counterpart is a public or private saving deficit. Others take the view that current account deficits might get “too large” but that it is hard to predict the size and timing of such a threshold due to its sensitivity to swings in investor aversion to risk.

Most Central and Eastern European countries have been running large current account deficits since the beginning of the transition. Such

deficits are to be expected for countries in the process of catching up, as domestic investment is likely to exceed domestic saving. For the 12 countries shown in Table 1, the current account deficits have averaged 4.5% of GDP during 1994–2002, with a peak in 1998 of 6.5%. There are wide variations across the region. Croatia has had slightly higher current account deficits (5% of GDP) and greater variability of deficits than the regional average. The Baltic countries have had the largest deficits (almost 7% of GDP on average). Slovenia's external account has been largely balanced.

*Table 1 Current account balances and FDI inflows<sup>1</sup>*

Countries	Current account	Net FDI inflows	FDI/Current Account
	Percentages of GDP		Ratio
Bulgaria	-2.2	4.0	1.80
Croatia	-5.1	3.6	0.70
Czech Republic	-3.8	6.7	1.75
Estonia	-6.8	5.5	0.80
Hungary	-4.5	4.0	0.90
Latvia	-5.7	6.2	1.10
Lithuania	-8.0	3.7	0.45
Poland	-3.9	3.5	0.90
Romania	-5.0	2.5	0.50
Slovakia	-5.5	3.4	0.60
Slovenia	-0.1	2.2	5.00
FR Yugoslavia <sup>2</sup>	-6.4	1.5	0.24
Average	-4.6	3.9	0.90 <sup>3</sup>

<sup>1</sup> Annual data, average for 1994–2002.

<sup>2</sup> Data for 1996–2002.

<sup>3</sup> Excluding Slovenia.

Sources: Deutsche Bundesbank, *Monatsbericht*, December 2002; UN Economic Commission for Europe; OECD Economic Outlook; author's calculations

Foreign direct investment (FDI) inflows have on average financed 90% of the current account deficits in Central and Eastern Europe (70% in the case of Croatia). Privatisation has had a significant influence on both the size and the volatility of such inflows. Nonetheless, for most countries, including Croatia, FDI inflows have actually been more stable than the current account imbalances. Bulgaria, the Czech Republic and Latvia have been particularly successful in attracting FDI. Slovakia was a relatively late starter with

respect to privatisation and FDI, but is now catching up rapidly. Net FDI inflows in Croatia were below the average for the region over 1994–2002, but over 1999–2002 the inflows increased to 5.5% of GDP per annum. Slovenia has relied on a policy of promoting domestic saving to finance investment. Consequently, few enterprises have been privatised and FDI inflows have been moderate.

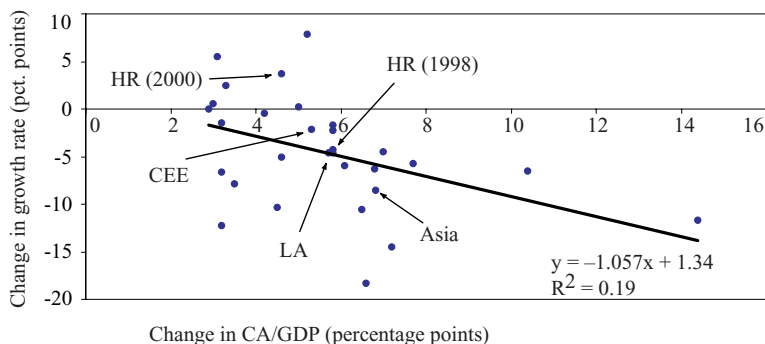
Thus, evidence that the Croatian economy has been running large current account deficits does not in itself indicate a fundamental weakness. The issue is, rather, how the economy adjusts to occasional surges in external deficits. To address this issue, Croatia's experience has been compared with recent episodes of current account reversals in a sample of 31 emerging economies over the period from 1995–2002.<sup>iii</sup> Following Edwards (2001), the reversal was defined as a fall in the current account/GDP ratio of 3 percentage points or more in one year. In the great majority of cases, this meant a reduction in the current account deficit or a swing from a deficit to a surplus.

Croatia experienced current account reversals in 1998 and 2000. The 1998 reversal was associated with a large decline in output – GDP growth fell by 4.25 percentage points (Figure 5).<sup>iv</sup> However, the reversal in 2000 was achieved without any loss in output – Croatia's growth rate actually increased by 3.75 percentage points that year. The reasons for this differing performance were both domestic and external.

- Domestically, 1998 saw a major banking crisis, with failure of several medium-sized banks (the largest one being Dubrovačka Banka). This resulted in a sharp drop in bank credit to the private sector and hence a decline in imports, production and household consumption. Externally, 1998 was marked by crises in Asia and Russia and failure of a large hedge fund (LTCM) in the United States, which threatened to cut off liquidity in international capital markets. The Croatian economy was thus exposed to both domestic and external shocks in 1998 and had to adjust the hard way: growth fell from 6.8% in 1997 to 2.5%; investment fell by 1% of GDP and the volume of imports by 8%.
- The situation in 2000 was quite different. The world economy, and in particular that of the EU, were still in an upswing, which provided an external stimulus to the Croatian economy. Domestically, the year 2000 was characterised by a sharp increase in public sector indebtedness, partly associated with the settlement of government arrears to enterprises. Together with export demand, this provided a moderate stimulus to the economy, so that the current account adjustment was

associated with a 3.75 percentage point increase in output growth and a 4% increase in the volume of exports.

Figure 5 Current account adjustment and change in GDP growth



HR = Croatia; CEE = Central and East Europe; LA = Latin America

Source: Author's calculations

Turning to the recent widening of the current account deficit – to 7.25% of GDP in 2002 and an estimated 9.5% of GDP in the first half of 2003 – the question arises which of the above two episodes provides a better indication of the likely pattern of adjustment of the Croatian economy. In particular, does the 2000 episode provide certain assurance that the large current account deficit can be corrected in an orderly manner, i.e., through slower growth of private consumption, investment and imports, and a moderate improvement in exports? Recent developments provide some grounds to expect such a scenario.

- First, the external environment improved considerably in the second half of 2003 and projections for 2004 foresee an acceleration of growth to 2% in Western Europe and 4% in the United States. Moreover, a cycle of tightening monetary policy in industrial countries is not expected to begin before the middle of 2004. Thus, the current account adjustment in Croatia should take place in a favourable international environment.

- Second, judging by preliminary balance of payments data for the third quarter of 2003 and projections for the full year, the Croatian economy is already adjusting the high current account imbalance. Private consumption is projected to slow to about 4.5% this year (from 6.5% in 2002), government consumption has continued to fall in real

terms, and investment has remained strong (a growth rate of 14% is projected for the full year; see Institute of Economics, Zagreb (2003)). Furthermore, after a good tourist season, the external sector could make a small positive contribution to growth this year.<sup>v</sup>

Based on these developments, one can be cautiously optimistic about the ability of the Croatian economy to adjust relatively smoothly to the run-up in the current account deficit in 2002 and the first half of 2003 in particular, so there is no need to tamper with the exchange rate. Such a course of action would unavoidably have wide-ranging negative effects on the economy, given that the balance sheets of banks, enterprises and households are heavily euroised, and given the large foreign currency-denominated public debt.

## FINANCING THE EXPANSION

A major factor contributing to the dynamism of domestic demand in Croatia over the past few years has been rapid expansion of banking sector credit. This development has raised a number of concerns, from worries about the deterioration of credit quality and increased banking system vulnerability, to fears that economic growth might falter should the lending boom subside. This section examines to what extent these concerns could be justified.

The first point to note is that the phenomenon of rapid credit growth has not been restricted to Croatia. Following a period of privatisation and restructuring, commercial banks in Central and Eastern Europe have been rapidly expanding their lending to the private sector since 2000. The growth rates of bank lending in Bulgaria, Croatia, the Czech Republic, Hungary, Romania and Slovakia have recently ranged from 20–110% per annum. These growth rates to a large extent reflect base effects: with the exception of Croatia, the share of household lending in overall bank credit is still very low in the region (Table 2), and the stock of bank loans in relation to GDP is low compared to industrial and the more advanced emerging market economies. As shown in Cottarelli et al (2003), even if all the increase in credit finances additional demand, a rapid rise in credit will lead to an overheating only if the initial stock of loans is sufficiently large in relation to GDP.

The second point is that Croatia is the only country in the region where the composition of commercial bank lending has evolved closer to that found in mature market economies. At around 45% of total



loans, the share of bank lending to households in Croatia is higher than the share of corporate loans and by far the highest in the region – loans to households have exceeded 20% of total loans only in Poland and Slovenia. By contrast, net claims on government, which are insignificant in Croatia, have ranged from around 20% of total loans in the Czech Republic and Slovenia, to 48% in Slovakia (Table 2). The more mature structure of bank lending and the relatively high initial stock of private sector credit (around 50% of GDP) are features that make Croatia potentially vulnerable to lending booms.

*Table 2 Composition of commercial bank lending, 2002<sup>1</sup>*

	Government <sup>2</sup>	Corporate	Household
Bulgaria	1.6	79.2	19.2
Croatia	5.9	48.9	45.2
Czech Republic	21.2	60.1	18.7
Estonia	6.3	56.3	37.4
Hungary	34.0	48.0	18.1
Latvia	7.2	74.6	18.1
Lithuania	36.5	53.1	10.4
Poland	26.2	43.8	29.9
Romania	23.7	58.9	17.4
Slovakia	47.5	41.5	11.0
Slovenia	21.6	54.9	23.5

<sup>1</sup> In percent of total credit, excluding interbank credit and credit to non-bank financial institutions. Data for end-2002 or the latest period available.

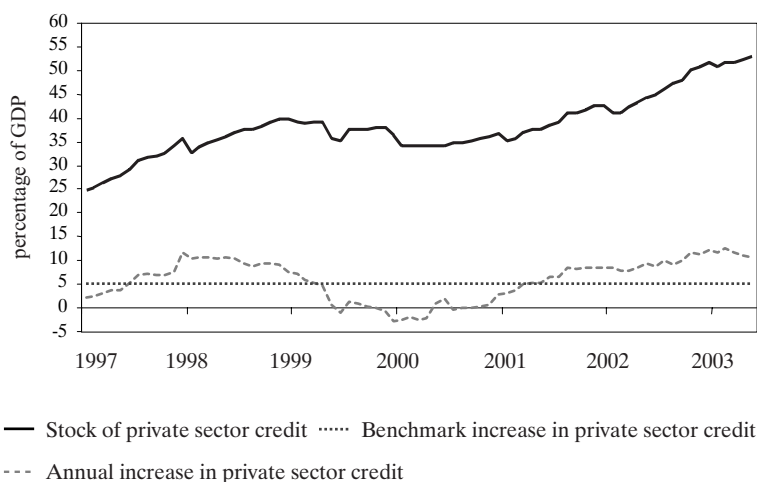
<sup>2</sup> Net claims on government.

Sources: BIS; IMF; national data

To what extent, then, has credit expansion in Croatia been “excessive”? A useful benchmark in this regard is the annual increase in credit equivalent to 5% of GDP or higher. Countries that experienced credit booms followed by a banking crisis have often seen credit expanding by 5–10% of GDP per year for an extended period (see Demirguc-Kunt and Detragiache, 1997). Credit growth in Croatia was above this benchmark from mid-1997 to early 1999, and has exceeded it again since March 2001 (Figure 6). During both booms, the annual increase in private sector credit peaked at around 13% of GDP. The first credit boom was followed by the banking crisis of 1998–99. The causes of that crisis were more complex, however, and were only partly related to the credit boom (see Kraft and Jankov (2003), and Vujčić, 2003). The second boom apparently started to subside in 2003.

One of the key differences between the two episodes is that the banking system in Croatia has become more robust since the late 1990s. Most banks have been privatised and are now partly or fully owned by reputable foreign banks. Reflecting better risk management and greater efficiency, prudential indicators have improved considerably in recent years: the share of non-performing loans declined by one-half since 1999; a high capital adequacy ratio has been maintained (close to 20%); provisions for loan losses have increased to 86% of non-performing loans (the second highest level in the region); and return on assets has more than doubled (Table 3). In addition, commercial bank liquidity has improved: the primary liquidity ratio (the ratio of highly liquid assets to deposits which are subject to reserve requirements) has increased from 1.3% at end-1999 to 3.3% in May 2003.

*Figure 6 Growth of private sector credit, January 1997-May 2003*



*Source: Croatian National Bank*

Nevertheless, one needs to wonder for how long banks can continue to expand their balance sheets by 10–15% per year without running into funding difficulties. Figure 7 indicates that, from mid-2000 to mid-2002, savings and foreign currency deposits of residents expanded at annual rates of up to 40%, making it possible to finance credit expansion entirely from domestic sources. Since mid-2002, however, the

growth of savings and foreign currency deposits has sharply decelerated, turning negative in December 2002 and becoming virtually flat in January 2003. At the same time, foreign liabilities have jumped sharply (by 14 billion kuna, almost 2 billion, between May 2002 and May 2003), implying that commercial banks have financed the continuing expansion of domestic credit almost entirely from foreign sources. This situation is unsustainable. Precautionary measures taken by the Croatian National Bank in 2003 to restrict the growth of commercial bank lending are thus justified.

*Table 3 Prudential indicators for the banking sector*

	Non-performing loans <sup>1</sup>		Capital adequacy <sup>2</sup>		Loan-loss provisions <sup>3</sup>		Return on assets	
	1999	2002 <sup>4</sup>	1999	2002 <sup>4</sup>	1999	2002 <sup>4</sup>	1999	2002 <sup>4</sup>
Bulgaria	29.0	13.0	43.0	29.0	9.9	8.7	2.5	2.2
Croatia	11.8	6.2	20.6	18.5	77.1	86.1	0.7	1.6
Czech Republic	22.0	13.7	13.6	15.4	52.2	59.1	-0.3	0.7
Hungary	3.6	2.6	14.9	13.9	52.6	53.8	0.6	2.0
Estonia	1.7	1.6	16.1	14.4	...	...	1.4	2.5
Latvia	6.0	2.8	16.0	14.2	79.3	80.4	1.0	1.5
Lithuania	12.5	8.2	17.4	15.7	...	...	0.5	1.0
Poland	13.2	17.8	13.2	15.0	104.4	102.0	1.6	1.4
Romania	0.7 <sup>5</sup>	0.7	42.7 <sup>5</sup>	55.0	...	...	1.5 <sup>4</sup>	3.1
Slovakia	23.7	14.0	29.5	21.9	6.4	2.5	-4.0	1.2
Slovenia	5.2	5.4	14.0	11.9	44.6	39.1	0.8	0.4

<sup>1</sup> As percent of total loans.

<sup>2</sup> Risk-weighted capital-asset ratio.

<sup>3</sup> As percent of non-performing loans.

<sup>4</sup> Data for end-2002 or the latest period available.

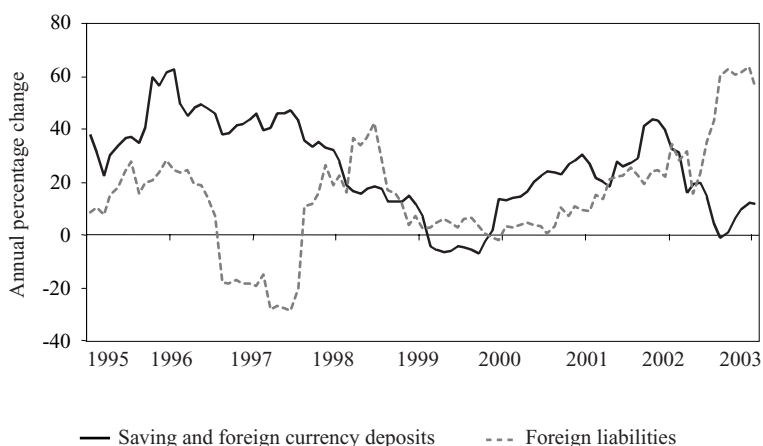
<sup>5</sup> Data for end-2000.

Sources: Central bank publications and websites; IMF country reports

Another potential concern is that greater competition among banks can result in excessive contraction of intermediation margins, affecting the financial position of banks. This has been a major issue in recent years for banks in the Czech Republic, Hungary, Poland, Slovakia and the Baltic states, as intense competition has pushed margins below or very close to those prevailing in banks located in Austria, Germany and Italy (Table 4). This situation is probably untenable in the medium term given the higher efficiency of banks in western Europe.

However, margins between lending and deposit rates, as well as between lending and interbank rates (a good indicator of banks' funding costs), are still relatively high in Croatia. This indicates that commercial banks in Croatia still have room for manoeuvre left and that their financial position may not immediately suffer in the case of a slowdown in business activity.

*Figure 7 Commercial bank liabilities, May 1995-May 2003*



*Source: Croatian National Bank*

In summary, there are reasons to remain cautious with regard to the financing of the recent lending boom. While prudential indicators point to a relatively sound banking system, one should keep in mind that these indicators are backward looking. On the other hand, there is evidence that credit growth to the private sector has entered a zone where increased vulnerability is not excluded. In particular, the surge in foreign liabilities of commercial banks raises both macroeconomic and prudential concerns.

Table 4 Bank intermediation margins

	BG	HR	CZ	EE	HU	LV	LT	PL	SK	SI	AT	DE	IT
Lending minus deposit rate													
End-2002 (or latest available)	7.1	6.9	2.5	4.1	2.5	3.5	4.2	5.9	4.2	3.9	3.2	3.7	4.4
Change since end-1999	-1.4	-1.4	-1.4	-2.2	-1.0	-4.9	-0.7	-1.0	-2.3	-0.7	-0.0	-0.2	0.4
Standard deviation	1.7	1.0	0.5	0.8	0.3	1.9	1.4	0.6	0.7	0.5	0.2	0.4	0.2
Lending minus interbank rate													
End-2002 (or latest available)	6.6	7.9	1.1	4.1	0.7	3.4	5.0	2.3	1.4	7.2	2.7	3.2	2.9
Change since end-1999	-2.6	-0.4	-1.0	-1.3	-0.2	-6.5	-3.8	-1.3	-3.4	-1.5	0.4	0.0	0.6
Standard deviation	1.8	0.8	0.5	0.8	0.3	2.3	2.6	0.9	1.2	1.0	0.3	0.5	0.4

BG = Bulgaria; HR = Croatia; CZ = Czech Republic; EE = Estonia; HU = Hungary; LV = Latvia; LT = Lithuania; PL = Poland; SK = Slovakia; SI = Slovenia; AT = Austria; DE = Germany; IT = Italy.

Sources: IMF; national data

## CONCLUDING REMARKS: PREPARING FOR CAPITAL INFLOWS

The Croatian public has for some time been presented with a fairly pessimistic assessment of the growth performance of the Croatian economy and the outlook for the external sector. According to this view, rapid expansion of bank lending to households and government borrowing for infrastructure projects have led to an unsustainable growth of domestic demand and imports. At the same time, it has been argued, Croatian exports have disappointed over the past decade because of an “overvalued” exchange rate, the lack of an “export strategy”, and failed privatisation and restructuring efforts. The result of such unbalanced growth has been excessive current account deficits and unsustainable increases in external and public sector debt. According to this view, then, a balance of payments crisis before or in lieu of the EU accession is more or less inevitable.

In contrast to this view, this paper has argued that clearer signs of healthier growth have emerged in the past 3–4 years. Moreover, the Croatian economy should be able to adjust to the widening external deficit in 2002–03 in an orderly manner. However, as regards the expansion in private sector credit, there are reasons for concern, and precautionary measures taken by the Croatian National Bank are justified.

Looking ahead, a major challenge for macroeconomic policy in the run-up to the EU accession could come from symptoms of “too great” success – i.e., large capital inflows – rather than the lack of success. If Croatia becomes an official EU candidate in 2004, it will have good chances to join the EU together with Bulgaria and Romania in 2007. This could lead to increased inflows of both long-term and short-term capital, putting pressure on domestic money supply, the exchange rate and aggregate demand. The Croatian economy, like other central European economies, has several features that make it susceptible to such inflows. The first such feature is the much higher (pre-inflow) rate of return on investment, reflecting imbalances in initial stocks of capital and a relatively rich endowment of skilled labour. This differential will induce capital inflows for so long as the present value of expected gains from investment exceeds the cost of funds to investors. The setting of macroeconomic policies will therefore need to take account of the strength of underlying investment demand that capital inflows represent.<sup>vi</sup>

The second such feature is the tendency for consumer price inflation in Croatia, as in other accession countries, to be higher than in

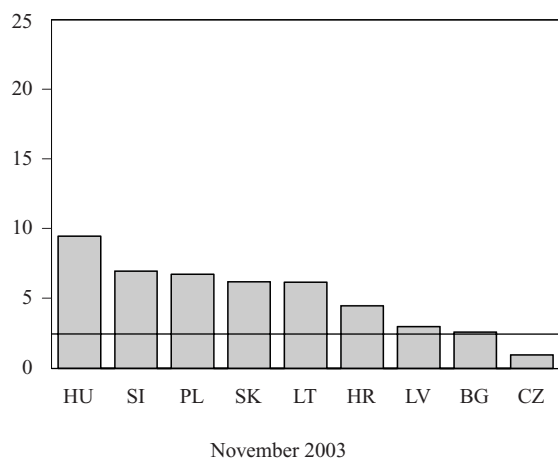
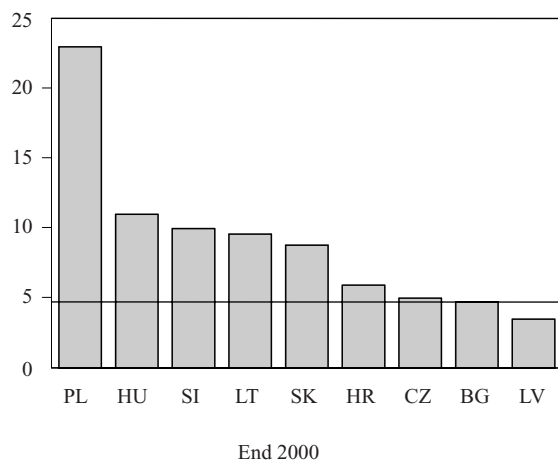
the euro area. This may reflect macroeconomic policies that are too lax (especially fiscal policy). But it may also reflect important real factors related to the transition process, in particular the tendency for prices of non-tradable goods to rise faster than the prices of tradables as real wages rise in the wake of rising productivity (the so-called Balassa-Samuelson effect; see Mihaljek and Klau, 2003). In countries with fixed exchange rates, these forces have manifested themselves in (CPI-based) real exchange rate appreciation, while in countries with floating exchange rates they have manifested themselves partly in nominal exchange rate appreciation, and partly in higher inflation. Given this inflation differential and the associated tendency of real exchange rates to appreciate, nominal interest rates in the accession countries have tended to be higher than in the euro area.

Such nominal interest rate differentials, although narrowing (Figure 8), remain sufficiently large to have an important impact on capital flows. The recent Hungarian experience illustrates this point vividly. Short-term inflows estimated at some 4–5 billion (equivalent to 7–8% of annual GDP) entered Hungary within only a few hours on 15–16 January 2003. The inflows were fuelled by both high interest rate differentials and the speculation that the 15% limit for appreciation of the forint above its central parity against the euro would be lifted. To deter inflows, the National Bank cut policy rates by 200 basis points within two days, introduced a quantitative restriction on short-term deposits, and intervened heavily in the foreign exchange market. While these extraordinary measures calmed speculation, lower interest rates combined with the ensuing depreciation of the forint have aggravated inflationary pressures, forcing the central bank to raise its inflation forecast for 2003.

A second problem potentially facing Croatia is that, like all emerging market economies, it remains exposed to capital flow reversals, especially if inflows result in both overvaluation and rising inflation. A particular concern is what might happen if the ambitious fiscal deficit reduction strategy were to go off track. Since non-residents are expected to become major buyers of newly issued public debt, given the promise of medium-term sustainability, such an event could lead to a sudden reversal of portfolio capital flows, causing the currency to depreciate sharply. This course of events can again be illustrated by the Hungarian experience. In mid-June 2003, monetary policy was tightened sharply after a poorly communicated decision to devalue the forint's fixed fluctuation band damaged investor confidence and trig-

gered heavy selling of domestic currency bonds. In order to reduce these risks and lessen the problem of capital flow reversals, Croatia would thus be well advised not to rush with liberalisation of the remaining capital controls.

*Figure 8 Official interest rates (%)*



*BG = Bulgaria; HR = Croatia; CZ = Czech Republic; HU = Hungary; LV = Latvia; LT = Lithuania; PL = Poland; SK = Slovakia; SI = Slovenia. The horizontal line refers to the euro area official rate.*

*Source: National data*



Third, large capital inflows might worsen pre-existing currency mismatches. While banks in Croatia are required to balance their open foreign positions by prudential regulations, by granting loans in euros they may simply replace foreign exchange risk by credit risk, as their customers may not be earning foreign currency. Because of such currency mismatches, Croatia's banking systems is highly vulnerable to volatile exchange rate movements. Furthermore, as debt is already skewed towards foreign rather than domestic liabilities, volatile exchange rate movements could also give rise to debt sustainability problems.

It should be emphasised that the policy challenges facing the accession countries in the presence of large capital inflows are largely independent of the exchange rate regime. Because the mechanisms motivating capital inflows are real rather than monetary, the only question is whether a real appreciation takes place through nominal appreciation or through inflation. Under a fixed regime (or a fixed but adjustable peg), capital inflows will reduce interest rates and increase investment relative to domestic saving. If inflation rises, external competitiveness would decline. Under a floating regime, capital inflows would lead the exchange rate to appreciate, again causing a loss of competitiveness and potentially generating a current account deficit. While various fundamental and institutional factors may impart some friction to this process, it is not likely that these frictions would be sufficient to afford the accession countries any significant interest rate autonomy, given capital mobility and the convergence of long-term interest rates to euro area levels.

In summary, policy makers in Croatia will have to conduct a very careful policy aimed at setting interest rates at an appropriate level: setting them too high would invite excessive short-term inflows, while setting them too low would lead to excessive investment and thus inflation. This is often referred to in the literature as the "Tošovský dilemma" (see Lipschitz et al., 2002b). As Croatia has limited capacity to respond to large movements in capital flows, it may find it necessary to satisfy the Maastricht criteria even before it becomes a member of the EU. This will require substantial fiscal adjustment in the next few years. Mobilising support for such adjustment will be difficult, however, given the large public expenditure needs and the fact that the deficits can be financed relatively easily at the moment.

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- i *For instance, the contribution of domestic demand is calculated as  $(DD_t - DD_{t-1})/Y_t - I$ , where  $DD_t$  is given by the sum of private and government consumption and fixed investment in year  $t$ , and  $Y$  is gross domestic product. By definition, contributions of individual components of GDP add up to the growth rate of the GDP.*
  - ii *The share of government consumption in GDP (22% in 2002) is smaller than the share of general government expenditure in GDP (50%), as the latter also includes redistribution through the pension and social security system (which is included in private consumption in national accounts) and public investment (which is included in gross fixed capital formation).*
  - iii *For details of the data sample and analysis, see Mihaljek (2003b).*
  - iv *The points in Figure 5 indicate changes in the growth rate of GDP (in percentage points, measured along the vertical axis) during different episodes of current account reversals (measured in percent of GDP along the horizontal axis). The regression line shows that, for each percentage point reduction in the current account deficit, the growth rate in emerging market economies declined on average by 1.06 percentage points.*
  - v *Exports of goods and services are projected to expand by 11% in 2003, and imports of goods and services by 8.8% (Institute of Economics, Zagreb (2003)). This would imply a decrease in the balance of goods and services and hence a positive contribution of net exports of about 0.25 of a percentage point.*
  - vi *Lipschitz et al. (2002a) estimate the marginal product of capital to be 8.5 times higher in the accession countries than in Germany, and on this basis calculate potential capital inflows at close to 5 times the initial (pre-inflow) GDP in central Europe.*

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